Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION—Colo. App.: Argument against note's security status fails to strike a chord, (Jun. 22, 2018)

Securities Regulation Daily Wrap Up

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By John M. Jascob, J.D., LL.M.

The Colorado Court of Appeals held that a promissory note sold by the defendant constituted a security under the Colorado Securities Act. Applying the *Reves* family resemblance test recently adopted in Colorado, the court rejected the defendant's argument that the promissory note was not a security because it was a personal loan with a term of less than nine months. Accordingly, the court upheld the defendant's convictions for securities fraud (*People v. Thompson*, June 14, 2018, Richman, D.).

The defendant had borrowed $2.4 million to continue development on a real estate project without disclosing to the investors that the lots were in foreclosure and his company had filed for bankruptcy. After the defendant defaulted on the promissory note and filed for personal bankruptcy, the State of Colorado charged the defendant with two counts of securities fraud and one count of theft. A jury found the defendant guilty on all three counts, and the trial court sentenced him to a combined term of 30 years in prison.

Presumptuous argument. On appeal, the court observed that the defendant's sufficiency of the evidence claim was premised solely on a novel interpretation of the Colorado securities laws. The defendant argued that his note was not a security because: (1) the term was less than nine months; and (2) the note strongly resembled a note that is not a security under the "family resemblance test" because it was an unconditional personal loan. In *People v. Mendenhall* (2015), decided the year after the defendant's trial, the Colorado Court of Appeals adopted the family resemblance test established by the U.S. Supreme Court in *Reves v. Ernst & Young* (1990) to determine when a note is a security.

In rejecting the defendant's first argument, the court noted that *Reves* explicitly declined to decide the question whether a note for a term of less than nine months was excepted from the presumption of being a security, while *Mendenhall* did not address the issue. Moreover, other circuit courts have held that the presumption does apply to notes maturing in less than nine months unless they are commercial paper.

The court also rejected the defendant's argument that consideration of the four family resemblance factors was sufficient to rebut the presumption that the promissory note is a security. First, the court found, a reasonable jury could infer that the defendant's purpose was to raise money for the development of the properties and that the investors' interest was primarily to profit from advancing money to defendant. Second, a transaction between only two entities may still be a security, even though there was no evidence that the note was traded under a "plan of distribution."

Turning to the third factor, the court found that the investors, as members of the investing public, would have reasonably viewed the transaction as an investment and the note as a security. Finally, the availability of a civil suit against the defendant did not constitute the existence of another regulatory scheme that significantly reduced the risk of the instrument.

Accordingly, the transaction involved a security under the Colorado Securities Act, and the evidence was sufficient to support the defendant's convictions for securities fraud.

The case is No. 14CA1332.

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